

COUNTY OF MILWAUKEE
Interoffice Memorandum

DATE: July 16, 2003

TO: Supervisor Richard D. Nyklewicz, Jr., Chairman, Committee on Finance and Audit

FROM: Jerome J. Heer, Director of Audits
Rob Henken, County Board Director of Research

SUBJECT: Midwest Airlines Agreement

ISSUE

On April 17, 2003, the County Board of Supervisors adopted Resolution File No. 03-265 relating to a proposed agreement to provide credit relief to Midwest Airlines. The resolution expressed the Board's conceptual support for the agreement, which was outlined in an April 8, 2003 report from the Director of the Department of Administrative Services (DAS). It also authorized DAS to conduct due diligence proceedings and pursue further negotiations with Midwest, and to then submit a formal agreement to the Committee on Finance and Audit and County Board for their consideration.

The formal agreement was submitted on July 11, 2003. This memorandum responds to a request from the Chairman of the Committee on Finance and Audit that the Department of Audit and County Board staff produce an analysis of the agreement for policymakers to assist them in their deliberations on this complex matter.

BACKGROUND

The April 8, 2003 report from the DAS Director outlined a proposed agreement under which the County would provide credit support for an outstanding balance of \$7.9 million of Industrial Development Revenue Bonds (IDRB's) that were issued by the City of Milwaukee in 1998 on behalf of Midwest to build a hangar for servicing larger planes. This would potentially free up operating cash for Midwest under its existing credit facility with local banks that supported the IDRB's. In exchange for providing its credit support, the County would require collateral from Midwest in the form of three hangars located at General Mitchell International Airport.

At the time, no formal appraisal of the hangars had taken place, but it was understood that the agreement would not move forward unless the hangars were found to have an appraised value of at least \$11 million, which was the minimum amount required to cover payments in support of the debt should Midwest Airlines cease to exist. In addition, the deal was to be contingent upon the agreement of local banks to make available to Midwest the value of the credit facility after the transaction was complete.

To further secure the County's position, the proposed agreement indicated that Midwest would provide a \$1 million payment to the County, the first \$100,000 of which would be assigned for payment of costs associated with negotiating an agreement, and the remaining \$900,000 of which would be placed into a reserve for payment of interest costs on the IDRB debt should Midwest fail to make payment on that debt, and to pay any legal costs incurred by the County in potential bankruptcy proceedings.

The formal agreement submitted on July 11 differs from the original proposal in the following major areas:

- Milwaukee County would now provide credit support for both the \$7.9 million outstanding balance on 1998 IDRB debt issued on behalf of Midwest *and* a \$6.3 million outstanding balance on IDRB Debt issued by the City on behalf of Midwest in 2001 for construction of a hangar to service Skyway planes.
- In order to adequately protect the County's support of this larger debt amount, the cash payment to be received by the County would grow from \$1 million to \$5 million. The additional \$4 million would be provided by Racine County via a Community Development Block Grant distributed by the State of Wisconsin, and would be placed in a reserve similar to the original \$900,000 for use on payments to support the IDRB's in the event that Midwest fails to make such payments. Approval by the Racine County Board of Supervisors still is required for this transaction to take place. This \$4.9 million reserve – plus the appraised value of the three hangars, which has been determined to be \$12.75 million – is considered by DAS to be sufficient collateral for the County's credit support.
- In light of continued concerns about Midwest's financial viability, the agreement requires Midwest to demonstrate a specified amount of monthly operating savings before the deal can be executed. Midwest announced a series of monthly cost savings in March – including a reduced operating schedule, reduced meal service and plans for a new "Saver Program" utilizing high-density seating for leisure destinations – that were designed to generate \$4 million per month in operational savings. Midwest has indicated that in order to avoid future operating losses, it must generate an additional \$2 million in monthly savings, which it has attempted to obtain through restructuring terms and conditions of leases with several lessors (\$1 million), labor union concessions (\$600,000) and productivity improvements that are largely associated with non-union personnel (\$400,000). The agreement indicates that Midwest must provide evidence that it has achieved monthly savings equivalent to at least 80% of the amount sought from its lessors and unions (\$1.28 million) prior to execution.
- As noted above, the original proposal anticipated a contingency that would require the local banks with whom Midwest had an existing credit facility to make available to Midwest the value of the credit facility after the County had relieved Midwest of its need to support the 1998 IDRB. This was designed to ensure that the County's assistance did in fact provide Midwest with the credit relief and additional cash flexibility that was intended. However, subsequent negotiations revealed that the banks were unwilling to make available the additional credit. Consequently, Midwest will attempt to use the assets that are no longer required to back the original credit facility to find a new lender for additional credit enhancement and cash borrowing. The agreement stipulates that Midwest must successfully obtain credit from another lending institution in an amount that is at least equal to the County's credit support, and must borrow against this line of credit, prior to execution.
- While the proposed agreement in April was designed and promoted as an integral component of Midwest's efforts to avoid a declaration of bankruptcy under Chapter 11 of the bankruptcy code, Midwest has indicated that the new agreement will have little impact on such a declaration. Instead, Midwest has said publicly that it can only avoid bankruptcy proceedings if it receives the concessions it is seeking from its labor unions, banks and airplane lessors. Consequently, the new agreement contains contingencies that would allow

it to go into effect under either a bankruptcy or non-bankruptcy scenario. If Midwest has commenced bankruptcy proceedings prior to execution of the agreement, it can only be executed if it is approved by the bankruptcy court. If Midwest has not commenced bankruptcy proceedings, then the agreement only can be executed if Midwest meets the conditions described above regarding monthly savings and the acquisition of a new line of credit, and if it also represents to the County that it has no present intention to file for bankruptcy.

Analysis and Discussion

The Midwest Airlines agreement would be effectuated by a complicated set of legal documents that have been prepared by attorneys working on behalf of both the County and Midwest. Furthermore, the structure of the deal – with its reliance on lease amendments, mortgages, etc. – is quite complex. We have reviewed the documents provided to us in the relatively short time frame that has been made available, and we have attempted to understand and reconcile the main components of the proposal and the risks to the County that would be involved in its execution to the best of our abilities.

On the whole, we believe that DAS has done a commendable job building contingencies into the agreement that will decrease risk to the County, and structuring the collateral arrangement so as to protect the County from immediate financial exposure should Midwest default on its obligations. Nevertheless, as DAS has readily admitted, there are risks associated with this proposal, and it is critical that policymakers fully understand those risks. The following attempts to describe the main issues and concerns surrounding those risks so that policymakers may take them into account as they consider the proposed Midwest Airlines agreement.

Midwest's Future Financial Health

As of the release of this report, Midwest had successfully negotiated concessions with its labor unions, and appeared to be nearing successful completion of negotiations with its banks and airplane lessors. However, even if Midwest achieves the cost-cutting measures identified in the proposal and successfully avoids bankruptcy in the immediate future, the viability of the airline within the initial five-year period of the arrangement remains a concern. After briefly reviewing Midwest's five-year business plan, we can foresee a scenario in which Midwest's fiscal situation will stabilize and it will return to a positive cash flow situation. However, in an era of continuing economic uncertainty and worldwide security concerns, it is also possible to foresee a scenario in which Midwest is unable to right its financial ship.

Furthermore, it is important to recognize that the steps that are deemed necessary by Midwest to avoid a bankruptcy filing in the near term will generate additional fiscal pressures in future years. As shown in Exhibit D of the Controller's memo dated July 11, 2003 outlining the proposal, Midwest's annual debt service payments related to this package would increase from \$494,000 to an estimated \$1,039,000, primarily related to interest payments associated with the additional credit anticipated as a result of the County assistance. Further, Exhibit E from the same memo shows Midwest's debt increasing substantially over the next two years and beyond (increasing from \$60 million in 2003 to \$90 million in 2005), primarily due to the acquisition of new, more cost-effective aircraft. There is also the notion of likely increases in lease payment obligations to the County associated with the variable-rate IDRB's, which are at historically low rates at present. When taken together, these realities convey the importance of Midwest

achieving not only its cost-cutting goals, but also the goal of generating additional revenues from increased passenger volume, in order to successfully navigate the near-term future. Consequently, while acknowledging Midwest's diligent efforts to generate cost savings and the prudent contingencies built into the agreement, policymakers must consider this agreement with an eye toward a worst-case scenario in which Midwest files for bankruptcy at some future date.

Legal Risks Associated with Potential Midwest Bankruptcy

Discussions with Corporation Counsel indicate that Milwaukee County has done a good job of establishing redundant protections to limit its exposure to negative financial consequences should Midwest either default on its obligation to make lease payments to the County, or petition the courts for protection from creditors under bankruptcy proceedings. These protections, as previously described, include collateral in the form of three Midwest hangars, as well as \$4.9 million in cash from Midwest and the State of Wisconsin. Additional protection is afforded by the stipulation that the ultimate goal of this proposal—freeing up Midwest assets currently pledged as collateral for current debt facilities so that it may be used to obtain an infusion of new credit—is achieved prior to enactment of the County package. It is clear, however, that none of these protections can be viewed as absolute, and there is considerable uncertainty as to just how extensive the negative financial consequences to Milwaukee County could ultimately be in the event of a worst-case scenario.

It appears that the County's legal risk would actually be clarified if Midwest were to file for bankruptcy prior to enactment of this package. In that scenario, the entire arrangement would require the approval of the bankruptcy court, thus affording the County sound legal standing for its claims to the collateral pledged to the County by Midwest. Absent such advance court approval, the enforcement of key terms of the proposed agreement, particularly the County's claim to the \$900,000 in cash and the rights to sell or lease the \$12.75 million Midwest hangars, is uncertain. In fact, it is possible that under a bankruptcy scenario, Midwest could be placed in a position of making legal arguments *against* the County's financial interest.

Greater detail on the legal risks associated with the proposed agreement will be provided by Corporation Counsel. Thorough discussion and contemplation of those risks is essential prior to a decision on this matter by the County Board.

Hangar Appraisals

The three hangars (two distinct properties, as one property is comprised of two hangars bridged by office and maintenance space) proposed by Midwest as collateral for the proposed agreement have been appraised at a total value of \$12.75 million. Setting aside, for the moment, any concerns about the legal certainty of the County's security claim to the hangars under certain worst-case scenarios, the realizable value of those hangars to the County in the event of a Midwest default and/or bankruptcy is a critical aspect of this proposal.

The County Board may proceed with some level of comfort given the professional opinion expressed by Valuation Research Corporation. However, it must be clearly understood that the unique purpose and features of the hangars, as well as the tremendous uncertainty of the air transportation industry in general, place a great deal of uncertainty on any market value appraisal for these properties at this time. It is difficult to quantify the pricing impact of selling or leasing the Midwest facilities under distress circumstances. The appraisal report notes that

industry insiders believe one or more airlines would be interested in filling the void created by a hypothetical Midwest demise. However, anticipating the terms under which any potential suitor would buy or lease either or both facilities is somewhat speculative in this volatile market.

In no way are the authors of this memo challenging the competence or professionalism of Valuation Research Corporation. Many mitigating factors, such as the lack of data on sales transactions involving truly comparable facilities, were specifically identified and taken into account by the appraisal team. It is imperative, however, that the County Board understand that estimating the impact, in terms of dollar value, of each of these factors requires a judgement call on the part of the appraiser. Consequently, an appraised value cannot be viewed as a guarantee of realizable value. Valuation Research Corporation has acknowledged as much, as noted in the **Assumptions and Limiting Conditions** section of the appraisal report:

“Our opinion is necessarily based on economic, market, financial and other conditions as they exist on the date of this report. While various judgments and estimates which we consider reasonable and appropriate under the circumstances were made by us in the determination of value, no assurance can be given by us that the sale price which might ultimately be realized in any actual transaction, if and when effected, will be at the Present Fair Saleable Value or Fair Market Value indicated.”

Other Issues

- **Nature of Relationship with Midwest.** Even if the County does possess sufficient legal protection to guarantee that it would receive ownership of the hangars in the event of a default on payments by Midwest, and even if the hangars could be leased or sold per the value estimated in the appraisal, it would be prudent for policymakers to consider some of the pitfalls that may be associated with a decision to exercise the County's legal rights. It is important to recognize that once the agreement is executed, Milwaukee County becomes, in essence, another of Midwest's lessors, by virtue of a credit assistance agreement that calls for payments to the County from Midwest as reimbursement for its credit support of the IDRBS. Those payments initially will total \$294,000 annually, but that amount could increase (or decrease) due to the variable rate nature of the IDRBS. If a situation arose in the future in which Midwest had not yet filed for bankruptcy, but was again seeking relief from lessors to avoid such a filing, the County could find itself in a delicate situation. For example, if Midwest determines that it cannot afford its annual payments to the County, would the County Board and County Executive be willing to refuse to grant relief if such action would lead to a declaration of bankruptcy? Alternatively, if Midwest simply stopped making its payments, would policymakers be willing to exercise the County's ownership rights to the hangars, even if it were clear that such action would lead to the airline's demise? This is not to suggest that Midwest has not or will not act in good faith in regard to its dealings with Milwaukee County. But it is important to recognize that the County is contemplating a business arrangement with a private entity that ultimately must act in its own business self-interest.
- **Long-term Scenario.** It is hoped that Midwest's financial situation will stabilize and ultimately improve to the point that it will no longer need the County's credit assistance. Consequently, under the Credit Assistance Agreement, Midwest agrees to use its "best efforts" during the initial five-year term of the agreement to obtain letters of credit from other

entities to secure the IDRB's without the County's assistance. If that should not occur, and if the bank with whom the County has a letter of credit is willing to extend the expiration date of the letter of credit, then the agreement specifies that the County will extend the Standby Reimbursement Agreement for an additional five years, provided that:

- a) a new appraisal has been performed that indicates the value of the collateral is still sufficient to protect the County's interests;
- b) Midwest agrees to fully amortize the bonds through their stated maturity by way of level debt service payments, assuming an interest rate of 5%; and
- c) Midwest agrees to fix the interest rate on the bonds for their remaining term or other such time period specified by the County.

The latter provisions reflect the fact that the IDRB's currently are structured as variable rate bonds with no principal payments to be made until the end of the 32-year maturity.

The County Board should be aware that the risk of Midwest not being able to obtain a letter of credit without County support is borne by the County. If Midwest is not able to obtain a letter of credit on its own, then upon expiration of the County's letter of credit, whether after the initial five-year term or after an extended term, the County will either have to continue to provide credit support or make good on its guarantee to pay the IDRB's. Hence, while the intent of the agreement is for the County to provide short-term assistance that will help Midwest in its efforts to navigate through a particularly difficult period, it is important to recognize that upon execution of the agreement, the County will bear ultimate responsibility for the IDRB's, and that responsibility could last until the bonds' maturation.

As noted above, this report has been prepared for informational purposes per the request of the Chairman of the Committee on Finance and Audit. The authors are available to address any questions or concerns related to this report.

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